

No. 10551

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United States  
Circuit Court of Appeals  
For the Ninth Circuit. <sup>14</sup>

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J. B. CLOVER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

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Transcript of the Record

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Upon Petition to Review a Decision of the Tax Court  
of the United States

FILED

OCT 28 1943

PAUL P. O'BRIEN  
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Circuit Court of Appeals  
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Upon Petition to Review a Decision of the Tax Court  
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES :

For Taxpayer :

GEORGE G. WITTER, ESQ.

For Comm'r. :

SAMUEL TAYLOR, ESQ.,  
R. C. WHITLEY, ESQ. [1\*]

Before the United States Board of Tax Appeals

Docket No. 99144

J. B. CLOVER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

### PETITION

The above named Petitioner hereby appeals from the decision of the Commissioner of Internal Revenue set forth in the latter's ninety day deficiency letter dated March 14, 1939, and as a basis of his appeal sets forth the following:

#### I.

(a) The Petitioner is an individual residing at No. 4190 South Western Avenue, Los Angeles, California.

(b) The deficiency letter, a copy of which is attached hereto, marked "Exhibit A", was mailed to the Petitioner on March 14, 1939. Said letter stated a deficiency in income tax for the year 1934, in the amount of \$545.36, and a deficiency for the year 1935 in the amount of \$13,130.24, and asserted a penalty for each of said years amounting to fifty percent (50%) of the deficiencies.

(c) The amount in controversy in this appeal is additional taxes for the years 1934 and 1935, in the total amount of \$13,675.60, and in addition thereto an [3] asserted penalty in the amount of \$6,565.12.



II.

With respect to the deficiency asserted for the year 1934, the Petitioner assigns the following errors:

(a) The Commissioner erred in determining that the Petitioner realized any gain from certain Condemnation Proceedings, in which the Petitioner lost riparian and littoral water rights pertinent to certain lands owned by the Petitioner in Mono County, California.

(b) In determining a gain from said Condemnation Proceedings, the Commissioner wholly failed to consider the basic cost to the Petitioner of said water rights and further failed to include more than a fraction of the expenses incurred by the Petitioner in the Condemnation Proceedings.

(c) The Commissioner erred in holding that the Petitioner received any gross amount in 1934 by reason of a judgment since appeal from said judgment was filed and pending on and after December 31, 1934.

(d) The Commissioner erred in imposing any penalty.

III.

The facts upon which the Petitioner relies in respect to the year 1934 follow:

(a) In 1934 and for more than ten years prior thereto the Petitioner was the owner of certain lands in Mono County, together with the water rights, both riparian and littoral pertinent to said lands. Said lands and water [4] rights had been

acquired by the Petitioner at a cost to him of over \$100,000.

(b) In 1930 the City of Los Angeles filed suits, seeking to condemn the water rights pertinent to the Petitioner's said lands. The Petitioner resisted said suits by employment of able counsel, the procurement of expert witnesses, and in every other legitimate way he could at an expense to him, amounting to over \$65,000.

(c) In 1934 two judgments were entered in said suits, one for \$68,000 in favor of the Petitioner as compensation for the riparian rights, and one for \$20,000 in compensation for the littoral rights. The Petitioner filed appeals from both of said judgments.

(d) In 1934 the City of Los Angeles paid into Court the amount of the judgment given for riparian rights, namely \$68,000. Of this sum the Court ordered \$5,625.00 to be impounded pending determination of the title to certain portions of the land. The Petitioner's appeals from both judgments were pending at the close of the year 1934.

(e) In the year 1935 there was paid to the Petitioner a further sum of \$61,000 on account of which and in consideration of which the Petitioner dismissed the two appeals that he had filed from the two judgments rendered, and assigned the \$20,000 judgment, which of record was not satisfied, to the Sierra Light & Power Company, who ostensibly had paid to him the \$61,000 [5]

(f) In filing his Return for the year 1934, the

Petitioner reflected thereon in gross income, the \$68,000 which was paid into Court in that year in satisfaction of one judgment and took as a deduction on his Return \$68,000 as damage sustained by him.

In filing his Return for the year 1935, the Petitioner reflected thereon as gross income an item of \$55,000 and took as a deduction a similar amount as damage sustained by him to property.

Petitioner realized no gain whatsoever from said Condemnation Proceedings, either in the year 1934 or 1935. Petitioner had no intention at any time, or under any circumstances to defraud the United States from any revenues to which it was entitled.

#### IV.

With respect to the deficiency assessed for the year 1935 Petitioner assigns the following errors:

(a) The Commissioner erred in determining that the Petitioner derived any profit whatsoever from certain Condemnation Proceedings.

(b) In determining gain or loss from Condemnation Proceedings in 1935, the Commissioner erred in omitting the Petitioner's basic cost of the water rights condemned and in including only a portion of the expenses paid and incurred in the Condemnation Proceedings.

(c) The Commissioner erred in imposing any fraud penalty on the Petitioner. [6]

#### V.

The facts upon which the Petitioner relies with respect to the year 1935 are stated in Paragraph III

above and said paragraph is hereby referred to and by this reference incorporated in this Petition at this point.

Wherefore, the Petitioner prays that the Board hear and determine its appeal and enter an Order of No Deficiency.

GEORGE G. WITTER,

Attorney for Petitioner, Citizens National Bank Bldg.,  
Los Angeles, Calif. [7]

State of California,  
County of Los Angeles—ss.

J. B. Clover, being first duly sworn on oath deposes and says: That he is the Petitioner in the above appeal; that he has read the foregoing Petition and knows the contents thereof and that the statements contained therein are true to the best of his knowledge, information and belief.

J. B. CLOVER.

Subscribed and sworn to before me this 7th day of June, 1939.

[Seal]

NETTIE BENTLEY,

Notary Public in and for said  
County and State.

My commission expires April 11, 1940. [8]

EXHIBIT "A"

Office of  
Commissioner of Internal Revenue

Treasury Department  
Washington

Mar 14, 1939.

Mr. J. B. Clover,  
4190 South Western Avenue,  
Los Angeles, California.

Sir:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1934 and 1935 discloses a deficiency of \$13,675.60 and \$6,565.12 in penalty, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Respectfully,

GUY T. HELVERING,

Commissioner.

(Signed) By JOHN R. KIRK,

Deputy Commissioner.

Enclosure:

Statement. [9]

## STATEMENT

IT:Aj

JC-33133-90D

Mr. J. B. Clover,  
4190 South Western Avenue,  
Los Angeles, California.

Tax Liability for Taxable Years Ended  
December 31, 1934 and 1935

	Income Tax			
	Liability	Assessed	Deficiency	50% Penalty
1934 .....	\$ 545.36	None	\$ 545.36	None
1935 .....	13,130.24	None	13,130.24	\$ 6,565.12
	<hr/>	<hr/>	<hr/>	<hr/>
Totals .....	\$13,675.60	None	\$13,675.60	\$ 6,565.12

This determination of your income tax liability has been made upon the basis of information on file in the Bureau.

The 50 percent penalty shown herein for the taxable years ended December 31, 1934 and 1935, has been asserted in accordance with the provisions of section 293 (b) of the Revenue Act of 1934.

Adjustment to Net Income  
Taxable Year Ended December 31, 1934

Income as disclosed by return .....	\$ 760.51
Unallowable deduction and additional income	
(a) Capital gain .....	10,205.18
	<hr/>
Net income adjusted .....	\$10,965.69

[10]

## Explanation of Adjustment

(a) Adjustment is made to include taxable profit realized as the result of damages awarded upon

the condemnation of riparian rights appurtenant to certain land owned in Mono County, California. The results of this transaction were reflected in your return as a nontaxable transaction by reason of reporting income from this source in an amount of \$68,000.00 and a corresponding loss allegedly sustained as damages to the property. Computation of the profit is set forth hereinafter.

Award of damages for riparian rights to 480 acres of land ....		\$68,000.00
Less:		
Sum impounded by the Superior Court of Tuolumne County pending settlement of a question raised by the administrator for the estate of Louis Samaan who claimed an interest in this land.....		5,625.00
		<hr/>
Net amount received during 1934 .....		\$62,375.00
Less:		
Legal fees paid in connection with the condemnation proceedings .....	\$26,735.32	
Value of water rights severed from land .....	1,622.40	28,357.72
		<hr/>
Net profit from severance of water rights from the land.....		\$34,017.28

The water rights having been acquired May 28, 1918 were held over ten years. The profit indicated above is therefore subject to the capital gain limitation of 30 percent which produces a taxable profit of \$10,205.18. [11]

## Computation of Tax—1934

Net income as adjusted .....	\$10,965.69
Less:	
Personal exemption (\$107.91 allowed on wife's separate return) .....	2,392.09
Balance surtax net income .....	\$ 8,573.60
Less:	
Earned income credit (minimum) .....	300.00
Balance subject to normal tax .....	\$ 8,273.60
Normal tax at 4% on \$8,273.60 .....	\$ 330.94
Surtax on \$8,573.60 .....	214.42
Correct income tax liability .....	\$ 545.36
Income tax assessed .....	None
Deficiency of income tax .....	\$ 545.36

## Adjustments to Net Income

Taxable Year Ended December 31, 1935

Income as disclosed by return ....	\$ 289.84
Unallowable deduction and ad- ditional income	
(a) Capital net gain .....	\$61,000.00
(b) Other income .....	1,000.00
Net income adjusted .....	\$62,289.84

## Explanation of Adjustments

(a) Adjustment is made to include profit from the assignment of an interest in a condemnation award made by a jury in October, 1934, for the littoral rights appurtenant to land owned in Mono County, California, as indicated below. [12]

This item was improperly reported on your return for the year as a nontaxable transaction by the incorrect designation as income from damage



to property by severance of water rights in an amount of \$55,000.00, and the deduction of a corresponding amount designated by the same description.

The correct income from this source is set forth below.

Cash received from the Southern Sierras Power Company for the assignment of interest in a condemnation award against the City of Los Angeles, California .....	\$ 66,625.00
Less:	
Attorney's fees paid during 1935 in connection with the assignment of the award .....	5,625.00
	<hr/>
Capital net gain, 100% subject to tax .....	\$ 61,000.00

(b) Income was also received in the amount indicated, represented by cash received from the Sierra Land and Water Company which had, in turn, been received from the Southern Sierra Power Company for any interest the Sierra Land and Water Company may have had in litigation involving Rush Creek water rights. This payment was received as a reimbursement for legal fees paid for the account of the Sierra Land and Water Company during 1934. All legal expenses paid during 1934 having been allowed herein as deductions for that year, this item represents income for the year 1935 in its entirety.

Computation of Tax—1935

Net income adjusted .....	\$ 62,289.84
Less:	
Personal exemption .....	2,500.00
	<hr/>
Balance surtax net income .....	\$ 59,789.84

Less:

Earned income credit (minimum) .....	300.00
	<hr/>
Balance subject to normal tax .....	\$ 59,489.84
	[13]
Normal tax at 4% on \$59,489.84 .....	\$ 2,379.59
Surtax on \$59,789.84 .....	10,750.65
	<hr/>
Correct income tax liability .....	\$ 13,130.24
Income tax assessed .....	None
	<hr/>
Deficiency of income tax .....	\$ 13,130.24
50% Penalty .....	\$ 6,565.12

[Endorsed]: U.S.B.T.A. Filed June 9, 1939.

[14]

[Title of Board and Cause.]

### MOTION TO AMEND PETITION

Comes now the Petitioner and respectfully asks leave to amend his Petition by adding thereto the following:

(To Paragraph IV of Petition:)

(d) The Commissioner erred in not applying a capital gain rate of Thirty Percent (30%) to the capital gain as determined by him for the year 1935.

(To Paragraph V of Petition:)

The \$61,000.00, in its entirety, received by the Petitioner in the year 1935 was money received from the disposition of a capital asset, namely water rights which had been owned by the Petitioner for over ten years and any profit resulting therefrom was subject

to the capital gain limitation of Thirty Percent. (30%).

(Sgd) GEORGE G. WITTER,  
453 So. Spring Street  
Los Angeles, Calif.  
Attorney for Petitioner.

[Endorsed]: U.S.B.T.A. Filed Feb 2, 1942. [15]

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[Title of Board and Cause.]

### ANSWER

Comes now the respondent, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed in the above entitled proceeding, admits, denies and avers as follows:

#### I.

(a), (b) and (c). Admits the allegations contained in subparagraphs (a), (b) and (c) of paragraph I of the petition.

#### II.

(a) through (d). Denies the allegations of error contained in subparagraphs (a) through (d) of paragraph II of the petition.

#### III.

(a) Admits so much of subparagraph (a) of paragraph III of the petition as states that in 1934 the petitioner was the owner of certain lands in Mono

County, California, together with the water rights, both riparian and littoral, pertinent to said lands, but denies that the said lands and water rights cost the petitioner \$100,000.00 or anywhere near such amount. [16]

(b) Admits that in or about the year 1930 the City of Los Angeles filed suits seeking condemnation of water rights pertinent to the petitioner's lands and that the petitioner resisted said suits, and for that purpose employed counsel, but denies that the defense of his interests cost him \$65,000 or anywhere near that amount.

(c) through (f). Admits the allegations contained in subparagraphs (c) through (f) of paragraph III of the petition, except respondent denies that the petitioner realized no gain from said condemnation proceeds in 1934 or 1935, and denies that petitioner's Federal income tax returns were not intentionally false and fraudulent, and denies that petitioner did not intend to defraud the United States of revenues justly due the Government.

#### IV.

(a), (b) and (c). Denies the allegations of error set forth in subparagraphs (a), (b) and (c) of paragraph IV of the petition.

#### V.

In answer to paragraph V of the petition, the respondent makes the same admissions and denials as he did with reference to the allegations of the petition in paragraph III and as he made with reference

to allegations in the petition with reference to the year 1934 that are similar to the alleged facts pertinent to the year 1935.

## VI.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore admitted, qualified or denied. [17]

For further answer to the petition, the respondent avers:

## VII.

(a) That the petitioner filed a false and fraudulent Federal income tax return for the calendar year 1935, therein substantially and flagrantly understating his gross income, net income and income tax liability for said year, all with the intent to evade the payment of taxes due and owing from him to the respondent.

(b) In his said 1935 return, the petitioner reported gross income in the amount of \$55,501.75 and deductions therefrom in the amount of \$55,211.91, net income in the amount of \$289.84, and no tax liability thereon, whereas in truth and in fact the petitioner received and should have reported gross income in an amount not less than \$62,501.75, was entitled to deductions in an amount not exceeding \$211.91, and should have taken no more; should have reported net taxable income in an amount not less than than \$62,289.84; and should have returned as his tax liability an amount not less than \$13,130.24.

(c) By reason of the petitioner's said fraudulent omissions and commissions in making return of his

1935 income, he became and is liable for the ad valorem penalty of 50% of the deficiency in income taxes due and owing from him for the year 1935, which penalty amounts to \$6,565.12. [18]

### VIII.

In support of the above set forth allegations of fraud taxes and penalty claimed to be due from the petitioner, the respondent states:

(a) In 1918, the petitioner and others promoted an irrigation project in the Mono basin, Mono County, California, in connection with which petitioner undertook to construct a ditch. Without cost to him, he acquired title to 480 acres of land situated on Rush Creek and the shore of Mono Lake. He also received a substantial portion of the capital stock of the Rush Creek Mutual Ditch Company as promotion stock, which stock he subsequently sold for approximately \$100,000.00.

(b) The alleged objects and purposes of the Rush Creek Mutual Ditch Company were to secure water rights, construct a ditch, and irrigate the desert lands of its stockholders in Mono County, California. However, because of prior rights to the waters involved, the company was unsuccessful and it never was able to get title to any water. A portion of the proposed ditch was constructed but it was always dry and was never connected with Rush Creek or any other waters. Apparently the undertaking was merely a stock-selling scheme and an effort to secure a color of title to valuable water rights which had become the object of a struggle for their possession

between a group of affiliated power companies on the one hand and the farmers located in the district on the other. In 1921, the [19] United States Department of the Interior denied the companies' application for a right of way for the proposed irrigation ditch across Government land. At that time the companies' project was definitely determined to be not feasible and further work on the ditch was abandoned.

(c) Subsequently, the City of Los Angeles began to acquire lands and waters in the Mono basin for the purpose of exporting the waters to Los Angeles for municipal purposes. The City purchased outright such lands and water rights as it was able to acquire at reasonable prices and proceeded with condemnation proceedings against such property as it could not so acquire.

(d) The said 480 acres of the petitioner became involved in the condemnation proceedings, petitioner contending for a value of \$500,000.00. In 1934, the petitioner accepted \$68,000.00 awarded for the riparian rights but declined to accept \$20,000.00 awarded him for the littoral rights, and appealed from the award.

(e) Certain power companies had sold, under the provisions of an executory contract dated October 20, 1933, lands and waters to the City of Los Angeles, the consideration therefor to be paid to the associated companies as provisions of the contract were fulfilled. One of the provisions was that all litigation affecting the water rights involved must be settled

prior to the payment of the final escrow. That provision made it necessary that petitioner's appeal from the \$20,000.00 award for his purported littoral rights be settled. As the amounts due the associated companies drew no interest, it became highly desirable [20] to them that the final escrow in the transaction be closed and that they get their money. Under the circumstances, petitioner's rights to the appeal from the \$20,000.00 award for littoral rights were of substantial value to the associated companies far in excess of the water rights involved. In 1935, petitioner succeeded in selling his award and all rights and claims in the litigation relative thereto to the associated companies for \$66,625.00 and made an assignment to the associated companies of his award and rights in the appeal from the award that was pending.

(f) For the year 1935, the petitioner reported but \$55,000.00 of the \$66,625.00 so received by him and claimed a deduction of \$55,000.00 as damages to property by reason of severance of the water rights so as to show no profit or loss on the sale, although, as a matter of fact, the petitioner sustained no loss or damage on account of the sale, the amount so received being wholly gain and profit.



Wherefore, it is prayed that the appeal be denied and that the tax and penalty shown in the deficiency notice be in all respects approved.

(Signed) J. P. WENCHEL,

Chief Counsel,

FTH

Bureau of Internal Revenue.

Of Counsel:

Alva C. Baird,

Frank T. Horner,

B. M. Coon,

Special Attorneys.

Bureau of Internal Revenue.

BMC/w 7/21/39

[Endorsed]: U.S.B.T.A. Filed July 31, 1939. [21]

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[Title of Board and Cause.]

**ANSWER TO AMENDMENT TO PETITION**

Comes Now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the amendment to the petition of the above-named taxpayer, denies as follows:

(To Paragraph IV of Petition:)

(d) Denies the allegations of error contained in subdivision (d) of paragraph IV of the petition, as amended by the amendment to the petition.

(To Paragraph V of Petition:)

Denies the allegations of paragraph V of the petition, as amended by the amendment to the petition.

Wherefore, it is prayed that the determination of the Commissioner be approved.

(Signed) J. P. WENCHEL,  
Chief Counsel, FTH  
Bureau of Internal Revenue.

Of Counsel:

Alva C. Baird,  
Division Counsel.

Frank T. Horner,  
Samuel Taylor,  
Special Attorneys,

Bureau of Internal Revenue.

[Endorsed]: U.S.B.T.A. Filed April 25, 1942.

[22]

The Tax Court of the United States

Docket No. 99144

J. B. CLOVER,

Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

GEORGE G. WITTER, ESQ.

For the petitioner,

SAMUEL TAYLOR, ESQ.,

For the respondent.

MEMORANDUM FINDINGS OF FACT  
AND OPINION

The Commissioner determined an income tax deficiency of \$545.36 for 1934 and an income tax deficiency of \$13,130.24 and a penalty of \$6,565.12 for 1935. Petitioner assails the determination of gain in the condemnation of water rights.

FINDINGS OF FACT

Petitioner, a construction engineer, is a resident of Los Angeles, California, and filed his income tax returns for 1934 and 1935 in the Sixth District of California.

In 1918, he entered into a contract with the Mono Valley Improvement Company to complete within three years the construction of a thirty-mile canal in Mono Basin. This project had been started about

1912 for the irrigation of desert land, and the Mono Valley Improvement Company had previously agreed to construct the canal for the Rush Creek Mutual Ditch Company. In consideration for petitioner's promise to do this work, the Mono Valley Improvement Company agreed to transfer to him 20,000 shares of Rush Creek Mutual Ditch Company, grading and camp equipment, promissory notes for a face amount of \$56,730.25 payable to the Mono Valley Improvement Company and secured by 4,000 shares of Rush Creek Mutual Ditch Company, a deed to 480 acres and a contract of purchase for 428 acres in Mono County, and all outstanding shares of the Sierra Land and Water Company. During 1918, petitioner received 18,169 shares of Rush Creek Mutual Ditch Company; the promissory notes, then in default; a deed to the 480 acres, which had riparian rights on Rush Creek and littoral rights on Mono Lake; and the 1,000 outstanding shares of Sierra Land and Water Company. At the time of receipt, the fair market value of the riparian rights in the 480 acres was \$2,957; that of the littoral rights was nil. Petitioner in years before 1929 realized \$28,445 in sales of some of the Rush Creek Mutual Ditch Company shares, collected \$710.33 on the promisory notes, and in 1936 sold the 480 acres, without riparian or littoral rights, for \$3,500. He realized nothing from the Sierra Land and Water Company shares and did not receive the other consideration mentioned in the contract. The Mono Valley Improvement Company ceased business in 1920.

During the years 1919-1935, petitioner was engaged in construction of the canal and also of lateral feeder ditches, not required by his contract. Some of the feeder ditches crossed his 480 acres which he used as headquarters for the construction work and, to some extent, for pasture. He kept no books of account for the work, but has checks and loose memoranda showing disbursements. The total cost to petitioner of the construction work was \$57,108.70. He filed no income tax returns for any of the years 1918 to 1933, inclusive.

Prior to 1930, the city of Los Angeles entered upon a large project for the use of the waters of Mono Basin. Water rights were in some instances acquired [23] by contract and in others by condemnation. In 1933, the city contracted to purchase from Nev-Cal Securities Company and other corporations their land holdings and water rights in the Basin. The contract provided inter alia that \$2,230,000 of the purchase price be paid in escrow and held until awards for condemned properties should be fixed. It provided further that \$100,000 of such awards be borne by the city and any excess by the sellers; special provisions covered several contingencies. On June 23, 1934, a judgment condemning the water rights of petitioner and others was entered in the city's favor. By it petitioner was awarded \$68,000 as compensation for his riparian rights in the 480 acres and \$20,000 as compensation for his littoral rights. Of the \$68,000 award, petitioner received \$62,375

in 1934 and \$5,625 in 1935, the latter having been impounded pending settlement of an adverse claim.

On November 21, 1934, petitioner filed notice of appeal from that part of the judgment awarding him \$20,000 for the littoral rights. On May 28, 1935, while the appeal was pending, petitioner sold and assigned all his right, title and interest in the \$20,000 award to Nev-Cal Securities Company, stipulating and agreeing that the assignee might prosecute any appeal or other proceeding in its own name. Petitioner made this assignment "for and in consideration of the sum of Twenty Thousand Dollars (\$20,000.00) to him in hand paid, by Nev-Cal." On the same date, he received from Nev-Cal \$41,000 "as consideration for the dismissal of appeal and waiver of right to appeal" by him. Petitioner filed a dismissal of the appeal and also a release and discharge of the city, the Department of Water and Power of the city, and the water and power commissioners from all liability growing out of the condemnation of his interest, "for and in consideration of the payment into court of the sum of Twenty Thousand Dollars (\$20,000.00) in satisfaction of judgment and the sum of Two Hundred Seventy-seven and 50/100 Dollars (\$277.50) costs \* \* \*, and in consideration of the payment to [him] of an additional sum of Twelve Thousand Dollars (\$12,000.00) by the Department of Water and Power of the City of Los Angeles."

As expenses of the condemnation proceedings, petitioner paid \$28,948.40 in 1934 and \$5,625 in 1935. Before, during and after the condemnation pro-

ceedings, petitioner occupied a leased office equipped with a telephone. He used the office and telephone during the period of the proceedings. In 1934, he paid \$240 for office rent and \$175.95 for telephone service. On his income tax returns filed for 1934 and 1935, petitioner stated that his books were kept on a cash basis. For 1934, he reported gross income of \$68,000 "from City of Los Angeles account damage to property" and deducted a like amount as damage to property. For 1935, he reported \$55,000 "Damage to property by severance of water rights" and deducted a like amount as damage. He claimed no loss from performance of a long-term contract.

### OPINION

Sternhagen, Judge: The petitioner filed no return for any year between 1917 and 1934. On his 1934 separate return, the total gross income shown was \$69,640, on which one item was \$68,000, "from City of Los Angeles account damage to property"; and the total deductions were \$68,879.49, of which one item was \$68,000, described as "damage to property by City of Los Angeles." The personal exemption of \$1,250 more than offset the net income of \$760.51 and no tax was shown. The Commissioner determined a deficiency amounting to \$545.36, by finding an adjusted net income of \$10,965.69, computed as follows: [24]

(a) Adjustment is made to include taxable profit realized as the result of damages awarded

upon the condemnation of riparian rights appurtenant to certain land owned in Mono County, California. The results of this transaction were reflected in your return as a non-taxable transaction by reason of reporting income from this source in an amount of \$68,000.00 and a corresponding loss allegedly sustained as damages to the property. Computation of the profit is set forth hereinafter.

Award of damages for riparian rights to 480 acres of land ....		\$ 68,000.00
Less:		
Sum impounded by the Superior Court of Tuolumne County pending settlement of a question raised by the administrator for the estate of Louis Samaan who claimed an interest in this land .....		5,625.00
		<hr/>
Net amount received during 1934 .....		\$ 62,375.00
Less:		
Legal fees paid in connection with the condemnation proceedings .....	\$ 26,735.32	
Value of water rights severed from land .....	1,622.40	28,357.72
		<hr/>
Net profit from severance of water rights from the land .....		\$ 34,017.28

The water rights having been acquired May 28, 1918 were held over ten years. The profit indicated above is therefore subject to the capital gain limitation of 30 per cent which produces a taxable profit of \$10,205.18.

In the petition, petitioner assigns as error (1) the determination that gain was realized from condemnation proceedings in which he lost riparian and



littoral rights pertinent to the Mono County property, (2) the failure in determining gain, to consider "basic cost" of the water rights and to include expense incurred in the condemnation proceedings, and (3) the alleged holding that petitioner received any gross amount in 1934 by reason of a judgment since appeal from that judgment was filed and pending on and after December 31, 1934.

On his 1935 joint return, the total gross income shown was \$55,501.75 of which one item was \$55,000, called "damage to property by severance of water rights;" and the total deductions were \$55,211.91, of which one item was \$55,000, called "damage to property by severance of water rights." The personal exemption of \$2,500 more than offset the net income of \$289.84 and no tax was shown. A deficiency was determined amounting to \$13,130.24 upon an adjusted net income of \$62,289.84, computed as follows:

(a) Adjustment is made to include profit from the assignment of an interest in a condemnation award made by a jury in October, 1934, for the littoral rights appurtenant to land owned in Mono County, California, as indicated below. [25]

This item was improperly reported on your return for the year as a nontaxable transaction by the incorrect designation as income from damage to property by severance of water rights in an amount of \$55,000.00, and the deduction of a corresponding amount designated by the same description.

The correct income from this source is set forth below.

Cash received from the Southern Sierras Power Company for the assignment of interest in a condemnation award against the City of Los Angeles, California .....	\$ 66,625.00
Less:	
Attorney's fees paid during 1935 in connection with the assignment of the award .....	5,625.00
	<hr/>
Capital net gain, 100% subject to tax .....	\$ 61,000.00

The assigned errors in the determination are (1) that petitioner derived any profit whatever from condemnation proceedings, and (2) the omission of basic cost of condemned water rights and the inclusion of only part of expenses of the condemnation proceedings. By an amendment filed at the hearing, an additional error was assigned in the failure to apply a capital gain rate of 30 per cent to the gain determined for 1935.

At the opening of the trial, respondent expressly "withdrew the fraud issue" and no evidence as to fraud was introduced. The issue is, therefore, out of the case, and no penalty addition to the deficiency may be assessed for either year.

Much of the time and testimony of the trial was devoted to proof of detailed construction costs during the years 1919-1935, all of which was disputed by respondent and all of which was objected to both generally and specifically. After the trial, counsel at the Court's suggestion, agreed upon a summation of this evidence, and a finding has been

made that the total cost of the construction work of the main and lateral feeder ditches was \$57,108.70. This finding, however, has no usefulness in the view we take of the case.

We must preface the discussion by saying that the contentions are not clearly defined and have not been uniformly or consistently maintained or clearly expounded. Petitioner received condemnation awards of \$68,000 for the riparian rights and \$20,000 for the littoral rights appurtenant to the 480 acres on Mono Lake which had been received in 1918 in consideration for his promise to do the construction job. The question is as to the gain from these awards, and the ordinary approach is to compare the amount received with the cost of the property condemned and treat the difference as gain or loss. This would seem to have nothing to do with the cost of petitioner's performance of a contract for construction on other property. But petitioner argues as if all of his cost of constructing the main and lateral ditches, whether on his own property or on property of others, is involved in ascertaining his gain or loss. The nature and design of petitioner's venture are not easily understood and therefore afford no help in considering a correct theory upon which to determine his income. In 1918, he had received the consideration for his promise to construct the canal in three years. The Mono Valley Improvement Company with which the contract was made has apparently long since gone out of existence. Petitioner had sold some of

the shares of the Rush Creek corporation, and respondent suggests that petitioner's venture was to derive a profit from the sale of shares. This petitioner resents, but offers no other explanation. If that were the fact, it can only be said that some of the Rush [26] Creek shares and the Sierra Land shares are still owned by him and are not the subject of gain or loss in the condemnation award from the water rights on the 480 acres.

Although petitioner in his pleading and at the trial suggested that he was contesting the determination that taxable gain was realized in 1934, he makes no such contention in his brief, but confines his argument to an attack on minor details of the computation. Specifically he seeks to increase the condemnation expenses relying on evidence of additional payments, and he seeks also to increase the basis for gain in the award for riparian rights. Upon the evidence we have found (as conceded by respondent) \$28,948.40 as the amount of expenses paid by petitioner in 1934 in connection with the condemnation proceedings and \$2,957 as the value of the riparian rights at the time of petitioner's acquisition. Since these two figures are larger than those used in determining the deficiency, the taxable gain for 1934 should be recomputed accordingly. The contention that amounts paid for rent and telephone are proper expenses of the condemnation proceedings incurred and paid in 1934 is rejected. The office and telephone were maintained by petitioner, regularly before, during, and after the condemnation proceedings. They were, therefore,

ordinary and necessary expenses of his regular business rather than expenses specifically connected with the condemnation, and are deductible from gross income and not a factor of capital net gain.

As to 1935, the \$66,625 received as a result of the condemnation proceedings is taxable as capital gain. This the petitioner does not contest. The amount is not in dispute and the deduction of \$5,625, paid as attorney's fees in that year, is regarded by each party as proper. Petitioner contends, however, that only 30 per cent of the resulting net gain of \$61,000 is taxable, and not the entire 100 per cent, as respondent has determined. Since \$5,625 of the gross proceeds represented an impounded portion of the \$68,000 award, it was obviously in payment for riparian rights held over 10 years and is, as was the portion received in 1934, subject to the 30 per cent limitation. In his brief respondent concedes that the \$20,000 received expressly for petitioner's assignment of his interest in the judgment award for littoral rights constituted proceeds from the disposition of a capital asset held over 10 years and that gain on it is taxable only to the extent of 30 per cent, and we so hold.

The \$41,000 received by petitioner in 1935 was not received from the city, which acquired his rights, but from Nev-Cal Securities Company. The payment was expressly described as consideration for the dismissal of the appeal. Relying on this characterization, respondent now argues that it is taxable as ordinary income. Petitioner insists that it was received as consideration for his water rights;

that the mere "mechanics of payment" are immaterial, and that it should serve as a factor in the computation of capital gain realized in 1935, being in reality consideration for the disposition of littoral rights.

The character of the \$41,000 payment appears in its declared purpose. The \$20,000 was the compensation for littoral rights; the \$41,000 was the consideration for dismissal of the appeal. The two were separate and their different characters may not be ignored for tax purposes; *MacDonald v. Commissioner*, 76 Fed. (2d) 513; *Marshall C. Allaben*, 35 B. T. A. 327. "The choice of disregarding a deliberately chosen arrangement" is not available to the taxpayer. *Gray v. Powell*, 314 U. S. 402. There is no lack of substance in the characterization of the \$41,000 as consideration for dismissal of the appeal. Prosecution of the appeal would have delayed settlement for very valuable water rights which the city was acquiring from Nev-Cal Securities Company and other power companies [27] and the amount of condemnation awards to others was to be a factor in determining the amount which Nev-Cal would receive from the city for its own lands and water rights. Hence, Nev-Cal had a substantial economic stake in the speedy settlement of condemnation awards and in keeping them down to a minimum. These economic benefits were a reason for Nev-Cal's payment of the amount and give it its character. As consideration received for petitioner's forbearance to exercise a legal right, it is ordinary income.

A substantial part of the evidence was given to establish costs incurred during the years 1919-1935, in carrying out the contract with the Mono Valley Improvement Company to construct a thirty-mile canal in Mono Basin. During the trial, petitioner's counsel contended, over respondent's objection, that evidence of these costs was relevant to establish basis for gain or loss in the condemnation award for the riparian rights and the littoral rights appurtenant to the 480 acres. In his brief petitioner does not suggest that such costs should serve to increase the basis for the water rights condemned, but uses them instead as a factor in the computation of a claimed "loss from construction costs in the year 1935, when he abandoned further work." He computes the loss by subtracting from the total cost the amounts which he collected in earlier years on the notes and proceeds from the sale of Rush Creek Company shares and the later sale of the 480 acres without water rights,—in short, the amount realized from the disposition of all the items received in 1918 as consideration for his promise to construct the canal, leaving out the awards for the condemned water rights. Such a claim is first asserted in petitioner's original brief and is not covered by any assignment of the petition.

In his reply brief, he asserts a claim to the use of the completed contract basis in computing the income resulting from the performance of the construction work. He keeps no books and prior to 1934 he filed no income tax returns. His returns for 1934 and 1935 were prepared on the cash basis.

In the absence of a well-adopted accounting method on the completed contract basis, he may not accumulate expenses of earlier years for deduction in the later year. He never adopted the completed contract basis and has failed to establish any foundation for the use of that basis now. He has maintained no accounting system, a necessary prerequisite for its use, *Dan Birkemeier*, 39 B. T. A. 1072, and his tax returns for 1934 and 1935 make no reference to the choice of such a basis, *Articles 42-4, Regulations 86*; cf. *Hageman-Harris Co. v. United States*, 87 Ct. Cl. 296; 23 Fed. Supp. 450, even if such a choice could be held to survive the fourteen years for which no returns were filed. It seems doubtful indeed that the proven costs are all related to the contract of 1918 which was to be completed in three years and made no reference to feeder ditches. No loss deduction is allowable.

Decision will be entered under Rule 50.

Entered: December 10, 1942. [28]



The Tax Court of the United States  
Washington

Docket No. 99144

J. B. CLOVER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

DECISION

In accordance with the Court's Memorandum Findings of Fact and Opinion, entered December 10, 1942, the respondent filed a computation of the deficiencies which came on for hearing on February 17, 1943. No objections having been filed, it is

Decided that there is a deficiency in income tax of \$406.40 for 1934, and a deficiency in income tax of \$8,382.85 and no penalty for 1935.

[Seal]

J. W. STERNHAGEN,  
Judge. [29]

Entered February 18, 1943.

In the United States Circuit Court of Appeals  
For the Ninth Circuit

Docket No. 99144

J. B. CLOVER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

### PETITION FOR REVIEW

To the Honorable the Judges of the United States  
Circuit Court of Appeals of the Ninth Circuit:

J. B. Clover, an individual residing in the City of Los Angeles, California, in support of his Petition filed in pursuance of the provisions of Section 1001 of the Revenue Act of 1926, for the review of the decision of the Tax Court of the United States rendered on February 18, 1943, finding a deficiency in income tax of \$8,382.85 for the calendar year of 1935, respectfully shows this Honorable Court as follows:

#### I.

##### Statement of the Nature of the Controversy

In 1918 the Petitioner acquired 480 acres of land in Mono County, California, together with the water rights appurtenant thereto. In or about the year of 1920, the City of Los Angeles began acquisition of water rights in Mono County by purchase and by condemnation. It instituted suit in the Superior

Court of California to condemn the Petitioner's water rights. In this suit judgment was entered in June, 1934, awarding the Petitioner \$68,000.00 for his riparian rights and \$20,000.00 for his littoral rights. In November, 1934, Petitioner took an appeal from that portion of [30] the judgment awarding him \$20,000.00 for littoral rights. In May, 1935, while the appeal was still pending, a settlement was effected of the litigation then pending, under the terms of which settlement the Petitioner received the sum of \$61,000.00. In making said settlement the Petitioner assigned all his right, title and interest in the \$20,000.00 award to the Nev-Cal Securities Company "for and in consideration of \$20,000.00 to him in hand paid by Nev-Cal." On the same date he received from Nev-Cal Securities Company \$41,000.00 "as consideration of dismissal of appeal and waiver of right appeal" by him.

Nev-Cal Securities Company had an agreement with the City for sale of its own lands and as part of said agreement had contracted to pay all awards made in condemnation suits in excess of a total of \$100,000.00.

In rendering this decision the Tax Court held that the \$20,000.00 received by the Petitioner in the settlement represented capital gain from sale of an asset held more than ten years, and therefore, taxable (under the Revenue Act applicable 1934) only to the extent of 30% thereof. It held that the \$41,000.00 was consideration received by the Petitioner from forbearance to exercise a legal right and was ordinary income taxable in full.

The Petitioner contended before the Tax Court and now contends that the entire \$61,000.00 received by him in the settlement was consideration received from the enforced sale of a capital asset held by him more than 10 years, and therefore, capital gain subject to tax to the extent of 30% thereof only.

## II.

### Designation of Court of Review

The Petitioner being aggrieved by the said decision of the Tax Court of the United States and having at all times had his residence in the City of Los Angeles, State of California, and having filed his income tax return for the calendar year 1935 [31] with the Collector of Internal Revenue of the Sixth District of California, desires a review of said decision by the United States Circuit Court of Appeals for the Ninth Circuit.

Wherefore, your Petitioner prays that this Honorable Court may review said decision and modify the same in accordance with the Petitioner's contentions.

J. B. CLOVER,

Petitioner.

GEORGE G. WITTER,

Attorney for Petitioner.

[Endorsed]: T.C.U.S. Filed May 8, 1943. [32]

The Tax Court of the United States  
Washington

Docket No. 99144

J. B. CLOVER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

CERTIFICATE

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 35, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 27th day of August, 1943.

(Seal)

B. D. GAMBLE,

Clerk, The Tax Court of the  
United States.

[Endorsed]: No. 10551. United States Circuit Court of Appeals for the Ninth Circuit. J. B. Clover, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of The Tax Court of the United States.

Filed September 14, 1943.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals  
for the Ninth Circuit.

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In the United States Circuit Court of Appeals  
For the Ninth Circuit

Docket No. 10551

J. B. CLOVER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

PETITIONER'S DESIGNATION OF POINTS  
ON WHICH HE RELIES AND PORTIONS  
OF RECORD DEEMED NECESSARY ON  
APPEAL

1. The Findings of Fact do not support the Conclusions of Law or Final Order of The Tax Court.
2. The Tax Court erred in holding that any portion of the \$61000.00 received by Petitioner in set-

tlement of condemnation suit was ordinary income and not capital gain from involuntary sale of a capital asset.

3. The Tax Court disregarded substance for form.

Portions of record designated by Petitioner:

1. Petition.
2. Amended Petition.
3. Answers.
4. Findings of Fact and Opinion of Tax Court.
5. Respondent's Proposed Recomputation filed January 16, 1943.
6. Final Order of Tax Court.

GEORGE G. WITTER,

Attorney for Petitioner

453 South Spring Street,  
Los Angeles, California.

[Endorsed]: Filed Sept. 28, 1943. Paul P. O'Brien, Clerk.





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No. 10551

IN THE

# United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

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J. B. CLOVER,

*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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## BRIEF FOR APPELLANT.

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### Statement of Pleadings and Jurisdiction.

The Commissioner of Internal Revenue issued to the petitioner a letter dated March 14, 1939, alleging a deficiency in income tax for the calendar years 1934 and 1935, and allowing the petitioner ninety days within which to appeal to the United States Board of Tax Appeals.

Within ninety days from March 14, 1939, the petitioner filed its appeal with the United States Board of Tax Appeals. The respondent duly filed his answer thereto.

The appeal was heard before Hon. John M. Sternhagen, a member of the Board of Tax Appeals, sitting at Los Angeles, California, in February, 1942. On December 10, 1942, the Board handed down its findings of

fact and opinion, and on February 18, 1943, entered its final order.

On May 8, 1943, the petitioner filed with the Clerk of the Tax Court of the United States his petition for review by the United States Circuit Court of Appeals (Ninth Circuit), and served a copy thereof and a praecipe upon counsel for the respondent. Appeal is taken as to the taxable year 1935 only.

### Statement of the Case.

The only question is whether the entire proceeds (\$61,000.00) paid to the petitioner in 1935 in settlement of condemnation proceedings was capital gain from an involuntary sale of his water rights, as contended by the petitioner, or whether only \$20,000.00 of such proceeds was such capital gain and the remaining \$41,000.00 was ordinary income realized from "forbearance to exercise a legal right," namely, his right to prosecute his appeal to a conclusion, as contended by the respondent.

The pertinent facts are as follows:

Petitioner had owned land and water rights in Mono Basin, California, since 1918. In 1931 the City of Los Angeles started proceedings in the Superior Court to condemn these water rights. In 1934 judgment was entered awarding the City the water and awarding petitioner \$68,000.00 for his riparian rights and \$20,000.00 for littoral rights. The petitioner accepted payment of the award for riparian rights but filed notice of appeal from that portion of the judgment awarding him \$20,000.00 for littoral rights. In May, 1935, while this appeal was still pending, a settlement of such appeal was

effected whereby petitioner received in 1935 \$61,000.00 cash. The petitioner contends that this entire \$61,000.00 was consideration realized from the enforced sale of his water rights and, therefore, capital gain, taxable only to the extent of 30%, having been held by petitioner for more than ten years. Respondent contends that only \$20,000.00 is such capital gain and that the balance, amounting to \$41,000.00, is ordinary income realized from "forbearance to exercise a legal right," namely, the right of petitioner to prosecute his appeal to a conclusion, and is, therefore, taxable in full.

The following facts pertain to the method and manner of settlement of the appeal and are so vital in this hearing that we quote the findings made by the Tax Court.

"Prior to 1930, the city of Los Angeles entered upon a large project for the use of the waters of Mono Basin. Water rights were in some instances acquired by contract and in others by condemnation. In 1933, the city contracted to purchase from Nev-Cal Securities Company and other corporations their land holdings and water rights in the Basin. The contract provided *inter alia* that \$2,230,000 of the purchase price be paid in escrow and held until awards for condemned properties should be fixed. It provided further that \$100,000 of such awards be borne by the city and any excess by the sellers; special provisions covered several contingencies. On June 23, 1934, a judgment condemning the water rights of petitioner and others was entered in the city's favor. \* \* \*

"On November 21, 1934, petitioner filed notice of appeal from that part of the judgment awarding him \$20,000 for the littoral rights. On May 28, 1935,

while the appeal was pending, petitioner sold and assigned all his right, title and interest in the \$20,000 award to Nev-Cal Securities Company, stipulating and agreeing that the assignee might prosecute any appeal or other proceeding in its own name. Petitioner made this assignment 'for and in consideration of the sum of Twenty Thousand Dollars (\$20,000.00) to him in hand paid, by Nev-Cal.' On the same date, he received from Nev-Cal \$41,000 'as consideration for the dismissal of appeal and waiver of right to appeal by him. Petitioner filed a dismissal of the appeal and also a release and discharge of the city, the Department of Water and Power of the city, and the water and power commissioners from all liability growing out of the condemnation of his interest,' for and in consideration of the payment into court of the sum of Twenty Thousand Dollars (\$20,000.00) in satisfaction of judgment and the sum of Two Hundred Seventy-seven and 50/100 Dollars (\$277.50) costs \* \* \*, and in consideration of the payment to (him) of an additional sum of Twelve Thousand Dollars (\$12,000.00) by the Department of Water and Power of the City of Los Angeles." [Transcript of the Record pp. 23-24.]

To make the issue clearer we set out below the portion of the opinion of the Tax Court treating of the issue raised in this review.

"The \$41,000 received by petitioner in 1935 was not received from the city, which acquired his rights, but from Nev-Cal Securities Company. The payment was expressly described as consideration for the dismissal of the appeal. Relying on this characterization, respondent now argues that it is taxable as ordinary income. Petitioner insists that it was re-

ceived as consideration for his water rights; that the mere 'mechanics of payment' are immaterial, and that it should serve as a factor in the computation of capital gain realized in 1935, being in reality consideration for the disposition of littoral rights.

"The character of the \$41,000 payment appears in its declared purpose. The \$20,000 was the compensation for littoral rights; the \$41,000 was the consideration for dismissal of the appeal. The two were separate and their different characters may not be ignored for tax purposes; *MacDonald v. Commissioner*, 76 Fed. (2d) 513; *Marshall C. Allaben*, 35 B. T. A. 327. 'The choice of disregarding a deliberately chosen arrangement' is not available to the taxpayer. *Gray v. Powell*, 314 U. S. 402. There is no lack of substance in the characterization of the \$41,000 as consideration for dismissal of the appeal. Prosecution of the appeal would have delayed settlement for very valuable water rights which the city was acquiring from Nev-Cal Securities Company and other power companies and the amount of condemnation awards to others was to be a factor in determining the amount which Nev-Cal would receive from the city for its own lands and water rights. Hence, Nev-Cal had a substantial economic stake in the speedy settlement of condemnation awards and in keeping them down to a minimum. These economic benefits were a reason for Nev-Cal's payment of the amount and give it its character. As consideration received for Petitioner's forbearance to exercise a legal right, it is ordinary income." [Transcript of the Record pp. 31-32.]

### Points Relied Upon by Petitioner.

1. The Findings of Fact do not support the Conclusions of Law or Final Order of the Tax Court.
2. The Tax Court erred in holding that any portion of the \$61,000.00 received by petitioner in settlement of the condemnation suit was ordinary income and not capital gain from involuntary sale of a capital asset.
3. The Tax Court disregarded substance for form.

### Statutes Involved.

Section 117 (a), Federal Revenue Act of 1934:

“(a) General Rule.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.”



### Summary of Argument.

Net proceeds realized from the involuntary sale of a capital asset are capital gain entitled to the benefit of the Capital Gains Section of the Revenue Laws. The entire \$61,000.00 was proceeds realized from the involuntary sale of petitioner's water rights. In holding that \$41,000.00 was for mere dismissal of appeal and not for water rights the Board has plainly disregarded substance for form. The settlement employed the ordinary forms used in litigation, consisting of assignment and satisfaction of judgment, dismissal of appeal, and release of all parties from further liability. There is no point in the fact that the Nev-Cal Securities Co. entered the transaction. Nev-Cal Securities Co. was in privity with the City and payment by that Company was the same as payment by the City. Following form the Board has construed as two transactions what in substance was only one. The Board, purporting to follow the forms executed by the parties, has necessarily failed to do so because the forms themselves are conflicting. The Board has completely ignored one form. There was no substance in the petitioner's appeal, except as it related to the subject matter of the litigation, that is, the water rights themselves. The amount paid on settlement of the appeal is determinative, not the amount of the award in the court below. If ulterior motives are in the mind of the buyer this does not, as the Board states, characterize the taxable transaction for the seller.

## ARGUMENT.

### I.

#### Net Proceeds From the Involuntary Sale of an Asset Are Capital Gain.

The subject is well covered in the decision of this Honorable Court in *Hawaiian Gas Products, Ltd. v. Commissioner*, 126 F. (2d) 4. In that case a loss had occurred and the taxpayer was contending that the eminent domain proceeding did not constitute a sale governed by Section 117 (b) of the Revenue Act of 1936. But the Court, after referring to the decisions of the Supreme Court in *Helvering v. Hamill*, 311 U. S. 504, *Electro-Chemical Engraving Co. v. Commissioner*, 311 U. S. 513, dealing with mortgage foreclosures, and *Iowa v. McFarland*, 110 U. S. 471, 478, defining "sale," held that the transaction was a sale within the capital gain provisions and limited the taxpayer to a \$2,000.00 loss. In that case the Court quoted with approval the following definition:

"A proceeding to condemn is, in substance, a proceeding to compel a sale by the owner to the petitioner \* \* \*."

In other cases the courts have gone further in holding that even interest included in a condemnation award on account of lapse of time is also to be treated as capital gain. *Seaside Improvement Co. v. Commissioner*, 105 F. (2d) 990 (C. C. A. 2); *Commissioner v. Estate of Edgar S. Appleby, et al.*, 123 F. (2d) 700 (C. C. A. 2).

In the instant case the Commissioner of Internal Revenue in the ninety day letter sent to the taxpayer designated the entire \$61,000.00 "*Capital net gain, 100% sub-*

ject to tax.” (Italics added.) [Tr. p. 11.] Also the Tax Court stated in its opinion [Tr. p. 31] as follows:

“As to 1935, the \$66,625.00 received as a result of the condemnation proceeding is taxable as *capital gain*.” (Italics added.)

Later in the opinion [Tr. p. 32] the Board stated as follows:

“As consideration received for petitioner’s forbearance to exercise a legal right, it is ordinary income.”

It is petitioner’s position that there was one transaction, not two; that the entire amount realized was capital gain from the enforced sale of his water rights and from no other source and, therefore, taxable only to the extent of 30%, under the provisions of Section 117 (*supra*).

## II.

### **In Arriving at Its Decision the Board Has Disregarded Substance for Form.**

The cases cited above make it clear that net proceeds realized from involuntary sale of a capital asset are capital gain. That much is not disputed. But the Tax Court says that because the parties in settling the litigation drew one form in which the judgment in court below was assigned for its amount, to-wit: \$20,000.00, and another form executed (on the same day) in which the appeal was to be dismissed for an added \$41,000.00, that there are two transactions to be construed, one resulting in capital gain wherein the asset was sold, the other resulting in ordinary income wherein petitioner surrendered his right to prosecute his appeal to a conclusion. By so

treating the transaction, we think the Board has reversed the established rule and let substance give way to form.

No principle is more clearly established in the decisions of the courts than that in matters of taxation substance, not form, will control. *Lynch v. Turrish*, 247 U. S. 221; *So. Pacific Co. v. Lowe*, 247 U. S. 330; *Gulf Oil Corp. v. Lewellyn*, 248 U. S. 71; *U. S. v. Phellis*, 257 U. S. 156; *Weiss v. Stearn*, 265 U. S. 242; *Tex-Penn Oil Co. v. Commissioner of Internal Revenue*, 83 F. (2d) 518 (C. C. A. 3); *Commissioner of Internal Revenue v. Schumacher Wall Board Corp.*, 93 F. (2d) 79 (C. C. A. 9); *First Seattle Dexter Horton Nat. Bank v. Commissioner of Internal Revenue*, 77 F. (2d) 45 (C. C. A. 9).

Any attorney who is a practical lawyer is acquainted with the ordinary procedure employed in settling litigation. A figure of settlement is agreed upon, which is the primary consideration, and then the lawyers draw the necessary forms to effectually dispose of the matter. The plaintiff is principally interested in the cash. The defendant, in addition to the cash, is interested in seeing that the litigation is ended and that he is protected from future claims.

In this case an assignment and satisfaction of judgment was made, a dismissal of the appeal was filed, and a discharge and release from further liability was executed. Those were just ordinary steps taken in settling litigation where there is a money judgment below.

If the judgment had been for "nothing" below, mere dismissal of the appeal would have been sufficient. Would the Board then have held that no part of the \$61,000.00 was for the asset condemned? Consistent with its an-

nounced principle it would have done so for the parties would have stipulated that \$61,000.00 was paid “as consideration for the dismissal of appeal.”

Nothing could be more erroneous than to treat the \$20,000.00 awarded in the court below as a measure of value of water rights. As long as the appeal is pending there was no finality in that judgment. The litigation was as unterminated as if the case had not been tried. The appeal was as much a part of the determination of what petitioner should receive for his water rights as trial in court below. The suit was still going on. The final payment made for dismissal of the appeal is the significant and determining thing, not the award below. Naturally, as a matter of form the added consideration, \$41,000.00, given in settlement was stated to be for dismissal of the appeal—and not in satisfaction of a \$20,000.00 judgment.

The Board emphasizes that Nev-Cal Securities Co. paid the money, not the City. There is no point in this. That Company was in privity with the City. It had agreed to pay all awards over \$100,000.00. [Tr. p. 23.] Payment by it was the same as payment by the City.

Also the Board suggests that Nev-Cal Securities Company had its own situation in mind and this induced it to make the settlement. Well, suppose it did, and suppose that situation had nothing to do with the value of petitioner’s water rights, it still would not characterize the transaction for this petitioner, as the Board states. This petitioner was the seller and he is the taxpayer. Obviously, ulterior motives in the mind of a buyer would not alter the tax status of a seller. But the Board states “Nev-Cal. had a substantial economic stake in the speedy

settlement of condemnation awards and in keeping them down to a minimum.” [Tr. p. 32.] This would surely indicate that Nev-Cal was fearful of paying more if the appeal were prosecuted to a conclusion and final value determined in court. If so, how can it be said that the money paid in settlement was not for water rights?

The difficulty in following forms is well illustrated in this case.

After saying that the parties must be held to the forms they executed the Board fails to do so in the following instances:

1. The document executed by the parties and filed with the Court recited that the \$20,000.00 was being paid “into court” but the Board finds it was paid “in hand” to the petitioner. [Tr. p. 24.]

2. The form filed with the Court recites that \$12,000.00 is paid by Department of Water and Power but the Board finds that the entire \$61,000.00 is paid by Nev-Cal. [Tr. p. 24.]

3. The Board finds that judgment was assigned to Nev-Cal but it is the petitioner who executes the satisfaction of judgment. [Tr. p. 24.]

4. The Board finds that \$41,000.00 was paid for dismissal of the appeal but form filed with the Court recites that \$32,000.00 is being paid for dismissal of the appeal and several other things. [Tr. p. 24.]

Again observe the lack of consistency in the forms executed: When the petitioner assigned his judgment he stipulated that assignee might prosecute any appeal in its own name. *On the same date* he agreed to dismiss the appeal himself. [Tr. p. 24.] The judgment was then over eleven months old. [Tr. pp. 23-24.]

Perhaps the above illustrates one basic reason for disregarding form in favor of substance. There may be conflicting forms but there can be only one substance. Often the Courts have been confronted with forms indicating two or more transactions which for taxation, following the rule of substance, they have determined to be one transaction. The following extract from *Paul and Mertens Law of Federal Income Taxation*, Vol. 2, Sec. 17.112 (4), is to the point:

“(4) The fact that two contracts are drawn to effectuate the purpose of the parties cannot convert one transaction into two separate and distinct transactions. *Comm. v. Moore*, 48 F. (2d) 526 (C. C. A. 10th, 1931), cert. den., 284 U. S. 620, 76 L. Ed. 528, 52 S. Ct. 8 (1932); *Comm. v. Garber*, 50 F. (2d) 588 (C. C. A. 9th Cir., 1931), petition dismissed 55 F. (2d) 1076 (C. C. A. 10th, 1931); *O’Meara v. Comm.*, 24 F. (2d) 390 (C. C. A. 10th, 1929).”

*First Seattle Dexter Horton National Bank v. Commissioner of Internal Revenue*, 77 F. (2d) 45.

But the cases above cited differ, in our opinion, from the instant case in that each of the contracts in those cases had some substance, whereas here we see no substance in the dismissal of the appeal separate and apart from the subject matter to which the appeal related.

The right to sue in the courts and appeal to protect property from unlawful taking may or may not be an inherent right in property itself but it is so clearly allied to the property that it is difficult to say it has existence as a thing separate and apart from the property. At least there must be a cause of action. As one of the laws of the land designed to protect property the right to sue and

appeal with respect thereto would seem to be one of the rights in the "bundle of rights" that constitute the property itself and enhance its value. In this sense then if form be followed, as the Board has attempted to do, disposition was made of a property right in dismissing the appeal and Commissioner correctly designated the gain "net capital gain" in the ninety-day letter. But he was in error in saying "100% subject to tax" since even this right to sue was acquired with the property and owned over ten years.

But it should not be necessary to resort to any such fiction where the transaction is plain as here. What was said by the Court in *Industrial Cotton Mills Co. v. Commissioner*, 61 F. (2d) 291, is peculiarly applicable:

"We think that the decision of the Board sacrifices substance to form. \* \* \* It is a settled principle that 'courts will not permit themselves to be blinded or deceived by mere form of law but, regardless of fictions, will deal with the substance of the transaction involved.' \* \* \*

"The rule just stated is of peculiar importance in tax cases; for, unless the courts are very careful to regard substance and not form in matters of taxation, there is grave danger on the one hand that the provisions of the tax laws will be evaded through technicalities and on the other that they will work unreasonable and unnecessary hardship on the taxpayer. It is instructive to note the many tax cases decided in recent years in which the courts have not hesitated to ignore corporate forms, and to decide



the questions involved in the light of what the parties have actually done, rather than on the basis of forms in which they have clothed their transaction.”  
(Citing cases.)

Equally pertinent is the language of this Honorable Court in its opinion in *First Seattle Dexter Horton National Bank v. Commissioner of Internal Revenue*, 77 F. (2d) 45, where it spoke as follows:

“Moreover, in view of the principle that, in applying income tax laws, the substance, and not the form, of the transaction should control, the exchange and sale of stock which was required under the whole contract herein should be treated as a single composite transaction for income tax purposes, regardless of the formalities followed. (Citing cases.) \* \* \*

“If a taxpayer sought to avoid a tax on the profits of such a sale as this by asking the Commissioner to ignore the actualities, he would shortly and properly be reminded that taxation is an intensely practical matter and that the substance of the thing done, and not the form it took, must govern.”

Apropos of what is suggested in the last paragraph above, suppose this petitioner had sustained a loss and were here contending he should be allowed to deduct the full amount thereof as an ordinary loss, on the ground that what he sold was not his water rights but merely his right to appeal. I think in that case both the petitioner and his counsel would “shortly and properly be reminded that taxation is an intensely practical matter and that the

substance of the thing done, and not the form it took, must govern.”

The most frequent case of settlement of litigation is dismissal of suit before trial for a consideration. Does this mean that nothing has been realized from the cause of action but that all is derived from “forbearance to exercise a legal right,” namely, the right to prosecute the suit to final judgment? We think not.

Respectfully submitted,

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